BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ESTATE OF ADAM HOLZWARTH, DECEASED,)
AND MARY HOLZWARTH)

For Appellants: H. R. Whiting
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Peter S. Pierson
Tax Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of the Estate of Adam Holzwarth, Deceased, and Mary Holzwarth against a proposed assessment of additional personal income tax in the amount of $451.60 for the year 1960.

The question for decision is whether a transaction whereby real property is transferred pursuant to a document which purports to be a lease is, for tax purposes, a sale or a bona fide lease.

From 1924 until 1960 Adam and Mary Holzwarth resided in a house located on a parcel of land which they owned in Menlo Park, California (hereafter referred to sometimes as "the Menlo property"). In 1957 the Holzwarths rejected an offer to purchase the Menlo property for $65,000, and in 1960 they declined to accept another purchase offer of $90,000. Prior to 1960 they had also received and rejected offers to rent the same property for $100 and $150 per month.

On May 11, 1960, Mr. and Mrs. Holzwarth and one Ray T. Lindsay (hereafter referred to as "Lindsay" or "lessee")

entered into an option-to-lease agreement relating to the Menlo property. During the option period Lindsay wanted to ascertain whether he could obtain a permit to build on the Menlo property and the Holzwarths wanted to arrange to have their house moved to another location. Lindsay exercised his option to lease by letter dated August 10, 1960.

On September 9, 1960, Adam and Mary Holzwarth, as lessors, and Lindsay, as lessee, executed a document entitled "LEASE" relative to the Menlo property. The term of the lease was 50 years, commencing September 12, 1960. The contract provided, in part, as follows:

* * *

3. Consideration for entering lease

Consideration from Lessee to Lessors for entering this lease payable upon execution thereof is the sum of $25,000.00; said sum is not a deposit for rent.

4. Rent

As rent, Lessee will pay to Lessors upon the 1st day of the month following the removal of lessors residence from said property, $400.00 and will continue to pay $400.00 rent in monthly installments on the 1st day of each and every month thereafter until the total of rent and consideration for entering the lease in the amount of $240,000.00 has been fully paid; . . . if Lessee has kept and performed all of the terms, covenants and conditions of this lease as of June 27,2005, the $25,000.00 paid as consideration for entering this lease shall be applied for the balance of said term and Lessee shall have no further obligation to pay rent for the balance of the term of this lease;

* * *

26. Option to Purchase

Lessor hereby grants to Lessee an option to purchase said property at any time on or after the first day of June, 1984 but not later than June 1, 1985 at

the price of $110,000.00 on account of which the total amount of consideration for entering this lease ($25,000) plus interest thereon at the rate of 5% per annum from June 1, 1960 to June 1, 1984 shall be credited and applied as follows:

$25,000 consideration. for entering lease
30,000 interest
$55,000 total credit

Other clauses of the agreement provided that: (1) the lessee would pay all taxes and assessments levied against the Menlo property during the term of the lease; (2) in the event that any of the property were condemned the lessee would still be bound by the terms of the lease, and any proceeds from such condemnation would be allocated. between lessors and lessee in accordance with their respective interests in the property; (3) lessee was to insure improvements placed on the property; (4) lessors would subordinate their interest in that property so that lessee could obtain secured construction loans; (5) lessee was required to maintain the property in good repair and free from any mechanics* or other liens; (6) lessee was prohibited from maintaining a nuisance or committing waste with respect to the property; and (7) lessors could terminate the lease if lessee defaulted with respect to any of its terms.

After the lease was executed. Mr. and Mrs. Holzwarth removed their house and placed it on another lot. The lessee then built a motel on the Menlo property.

The Holzwarths' use of the Menlo property for residential purposes after 1953 was a nonconforming use under a local zoning ordinance, since the parcel had been classified as commercial property, In 1949 the City of Menlo Park had adopted a street and highway plan pursuant to which the rear portion of the Holzwarths' property would be taken under the city's eminent domain powers for use as an alley. In constructing the motel the lessee left vacant the area designated for construction of the alley.

In a statement dated May 18, 1965, which is contained in the record, Lindsay averred that he intended and understood the agreement between him and the Hoizwarths to be a lease. He stated further:

> When this lease was entered into and payment under the above document made, We had no other thought in mind but that We would exercise the "option to purchase" at the proper time, and this is still our intent, barring any unforeseen "calamity" which might occur. In fact, we honestly believe that our *chances* of purchasing this property exceed ninety (90%) percent,

In their federal income tax returns for 1960 the Holzwarths reported the $25,000 received pursuant to the lease agreement as capital gain; The Internal Revenue Service determined that that amount was taxable as ordinary income. Mr. and Mrs. Holzwarth petitioned the United States *Tax* Court for *review of* that determination.

For California personal income tax purposes Adam and Mary Holzwarth filed a joint return for 1960 which showed no tax due. On February 25, 1965, respondent issued its notice of proposed assessment against appellants, incorporating the federal adjustments. That notice was protested by appellants, Subsequently respondent affirmed its action when the Tax Court ruled in favor of the federal government. (Estate of Adam Holzwarth, T.C. Memo., Nov. 22, 1965.)

Appellants' principal contention is that the subject transaction was in substance a conditional sale rather than a lease. They argue that the amount received by the Holzwarths in 1960 under that agreement represented part of the selling price of the Menlo property. In the alternative appellants contend that the $25,000 payment constituted a loan, a condemnation award "in-effect" for a portion of the property, part of a nontaxable exchange, or the purchase price of an option,

Respondent contends, as did the federal government, that the agreement in question was a lease, as it purported to be, and that the $25,000 received by the Holzwarths in 1960 was what it was stated to be in the *lease,* i.e., a payment made by the lessee as consideration for entering the lease, and it was therefore taxable as ordinary income in the year of receipt.

In determining whether a transaction is to be considered a sale or *a* lease for tax purposes, courts look to the substance of the transaction. The essential nature of a transaction is not necessarily controlled by the labels which the written documents bear. (Franklin Leon Alexander, T.C. Memo., Mar. 19, 1958.) Whether what is in form a lease

is in effect a conditional sales contract depends on the intention of the parties, (Benton v. Commissioner, 197 F. 2d 745.) Where the "lessee" as a result of the "rental" payments acquires something of value in relation to the overall transaction, other than the mere use of the property, he is building an "equity" in the property and the payments do not, therefore, constitute runt but are part of the purchase price of the property. (Haggard v. Commissioner, 24 T.C. 1124, aff'd per curiam, 241 F.2d 288; Judson Mills, 11 T.C. 25,)

In disposing of appellants' case at the federal level the Tax Court considered the evidence contained in the record, including the lease agreement itself, and determined that that agreement was a lease, in substance as well as in form. (Estate of Adam Holzwarth, supra, T.C. Memo,, Nov. 22, 1965.) In reaching this conclusion the court reasoned that since the rental payments due under the lease agreement were not shown to be in excess of the property's fair rental value, It could not be said that merely by paying rent the lessee was acquiring anything other than the mere use of the property. The court also noted that after 25 years of making rental payments Lindsay would still have to pay the very substantial sum of $55,000 in order to become the *owner* of the property.

The Tax Court next considered the nature of the $25,000 payment which Lindsay made to Adam and *Mary* Holzwarth upon execution of the lease, The court conceded that, under the terms of the lease, the Holzwarths did not know in 1960 whether the payment would be applied ultimately (1) for rent, or (2) as part of the purchase price. It observed, however, that they had full use of the $25,000 upon receipt, and there was no provision in the lease for return of that money to Lindsay, whether or not he exercised the option to purchase the property. The court concluded that the $25,000 payment *to* the Holzwarths was made primarily as consideration for entering the lease and therefore constituted ordinary income to them in 1960.

The Tax Court disposed of appellants' alternative argument3 as follows:

> Petitioners' alternate contentions that the payment constituted (1) a right to a condemnation award "in-effect" for the house or the alley, (2) a loan, or (3) part of a nontaxable exchange are without basis in law and are contrary to the facts, and do not merit any discussion herein.

Faced with this adverse decision appellants contend that (1) the United States Tax Court's decision was incorrect, and (2) it is not controlling here since the Ninth Circuit Court of Appeals has reached the opposite conclusion and its views should represent the governing law where a California taxpayer is concerned. In support of this latter argument appellants rely primarily on Oesterreich v. Commissioner, (9 Cir. 1955) 226 F.2d 798.

The issue before the Tax Court in Estate of Adam Holzwarth, supra, T.C. Memo., Nov, 22, 1965, was identical with the one raised by this appeal, In view of that fact the disposition of the case at the federal level is highly persuasive of the result that should be reached here. (Appeal of Reginald G. and Mary Louise Hearn, Cal, St, Bd. of Equal., May 10, 1967.) Appellants make substantially the same arguments here that they made unsuccessfully before the Tax Court, No evidence has been presented to us which was not considered by that tribunal, The case of Oesterreich v. Commissioner, supra, was also brought to the attention of the Tax Court and was held to be distinguishable on its facts. That case involved a long term lease with a nominal sum payable for the exercise of an option to purchase. The other cases cited by appellants similarly involved distinct fact situations,

With regard to appellants* contention that the $25,000 received by Mr. and Mrs, Holzwarth in 1960 constituted the purchase price of an option, the very terms of the agreement negate that conclusion., In the agreement the $25,000 is stated to be consideration for entering the lease. The Tax Court affirmed that characterization, Since there is no evidence to support appellants' contention, we must reject it.

Upon review of the entire record we find nothing which would justify our reaching a different conclusion than that of the United States Tax Court in this matter. Respondent's action must therefore be sustained,

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Estate of Adam Holzwarth, Deceased, and Mary Holzwarth

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of the Estate of Adam Holzwarth, Deceased, and Mary Holzwarth against a proposed assessment of additional personal income tax in the amount of $451.60 for the year 1960 be and the same is hereby sustained.

Done at Sacramento, California, this 12th day of December, 1967, by the State Board of Equalization.

Paul R. Leake, Chairman

Member

Member

Member

Member

ATTEST: Acting Secretary